DOW THEORY LETTERS INC.

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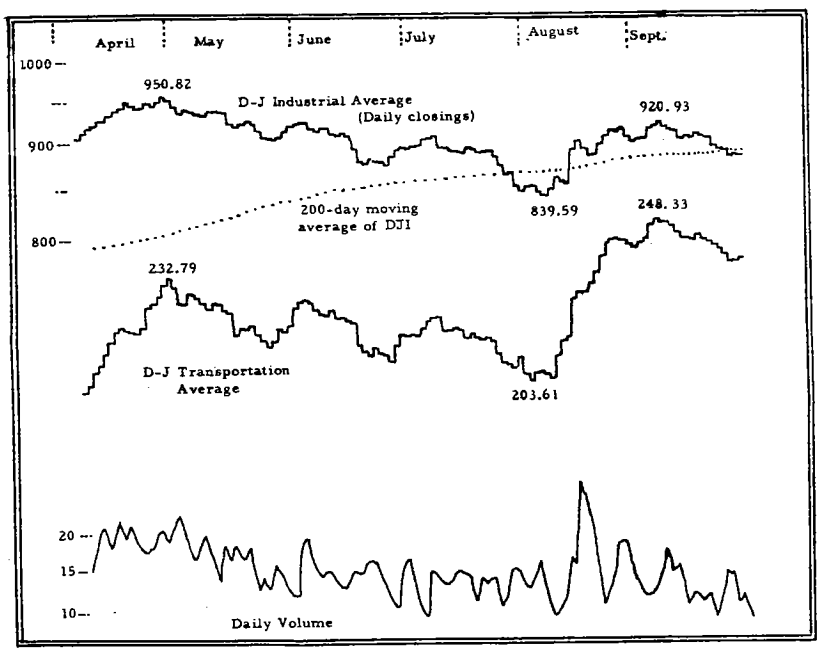
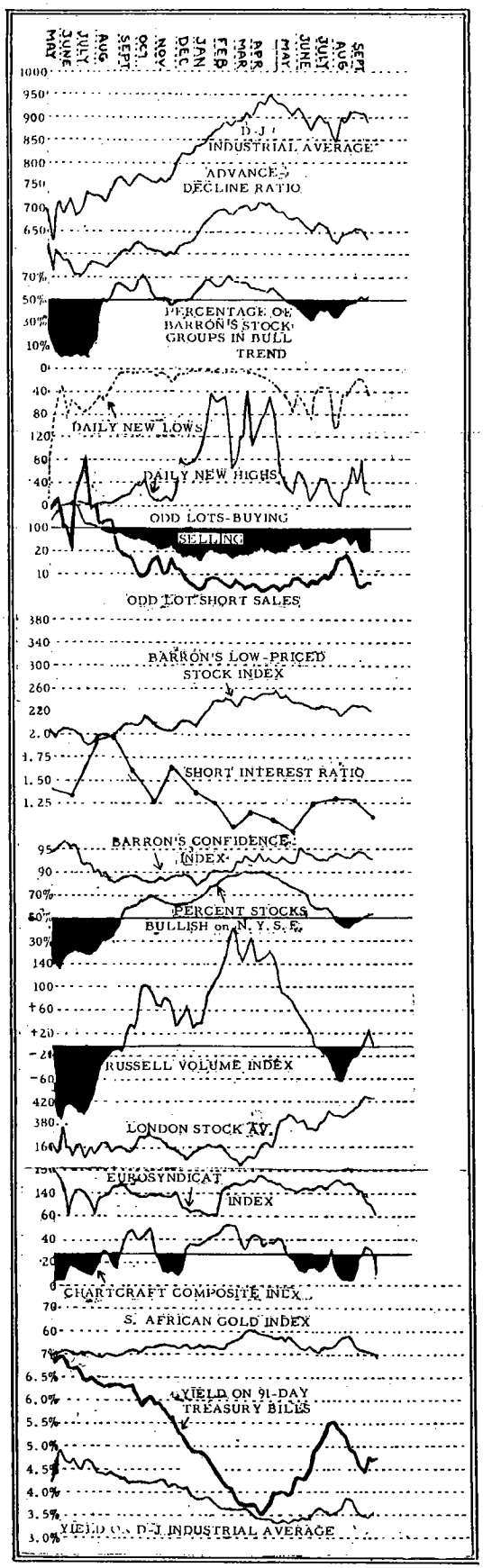
THE MARKET: In the last Letter I referred to this market as a "technical hodge-podge of non-confirmations and out-of-gear movements". Very little has changed since then — except that the market has shown a proclivity to "get it all together". The direction of that "togetherness", as is so often the case during primary bear markets, has been on the downside. As far as damage is concerned, I would say that the main technical damage has been the September 27 penetration of the 200-day moving average by the D-J Industrials. This downside penetration (see page 1 chart) is, I feel, particularly significant since it is the second downside penetration of the 200-day moving average this year (the first penetration having occurred in August). As a rule, the second penetration carries very bearish connotations, particularly, as now, when the 200-day moving average has flattened out (during the earlier August penetration the moving average was still advancing).

The second area of technical damage pertains to the Utility Average, which (as I have been drawing attention to in recent Letters) is now moving to new lows for the year in a most authoritative way. This is documented on the page 2 chart, and I have up-dated this chart from the last Letter.

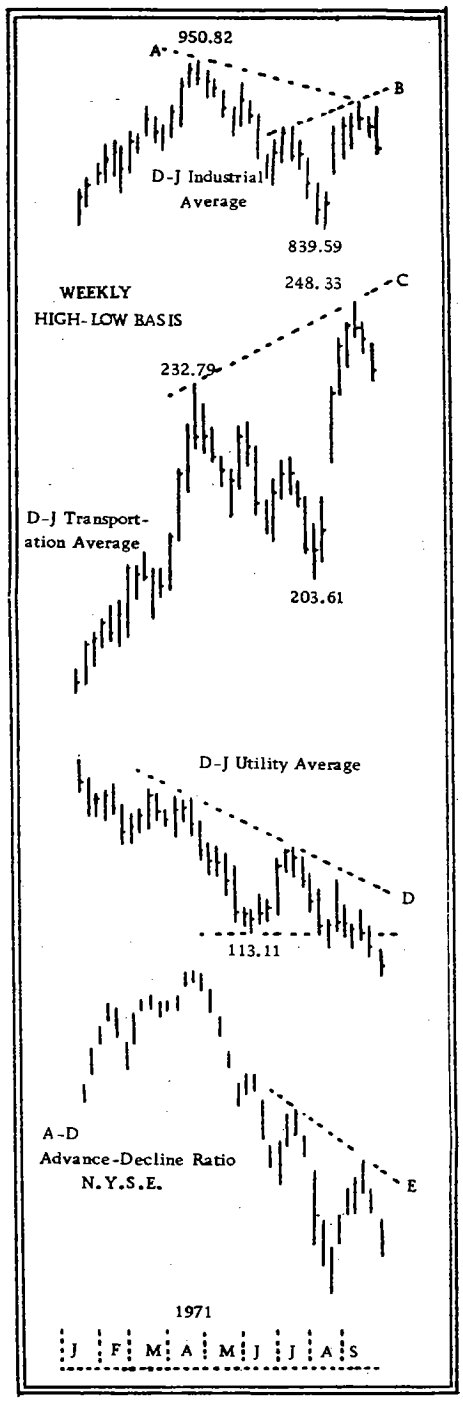
Note again (see page 2 chart) that since April, 1971, a flagrant non-confirmation has existed between Industrials and Transports with the Industrials having been unable to better their April peak. Since July there has been an equally flagrant non-confirmation between Industrials and the advance-decline ratio, for while Industrials did better their July 12 peak of 903.40, the advance-decline ratio has never even approached its comparable July peak. In the meantime, the Utilities are at new lows for the year. Thus the four leading indicators shown on this weekly chart are badly out-of-gear, and the major technical question facing the market today is whether the ultimate resolution of this series of non-confirmations will be on the upside or the downside.

Personally, I believe that the entire picture as shown on the page 2 chart is one of bearish distribution (when the Averages get hopelessly out-of-gear it is always a





fair assumption that distribution is taking place). Furthermore, non-confirmations and out-of-gear movements are the norm near the top of an advance in a primary bear market. Therefore, I feel that the page 2 chart constitutes a textbook example of deterioration near the peak of a major bear market rally. At times the movements of the market seem dull, listless and interminable. At other times the changes are so rapid that the month-to-month action fairly boggles the mind. I believe we are now entering a period in which violent change will be the rule, and in view of this I must say that this quote from the famous Dow Theorist, E. George Schaefer, caught my eye last week: "It will be most interesting to look back on this entire picture about next June, 1972. How many investors will have lost their shirts by then? I would say 90% to 95% or more....and a depression will be on." (From the Sept. 25 Schaefer report, 916 E. 38th St., Indianapolis, Indiana 46205).



Many readers may treat that quote with scepticism, but I warn them that Mr. Schaefer has a feeling for the primary trend second to none (and his record proves it). Mr. Schaefer also knows that when a primary bear market (as this one) has been held back for five years, the downside risk becomes increasingly ominous. Despite the fact that Mr. Nixon is now telling 30 million investors what they want to hear, despite the fact that the funds and the institutions and the pension funds are now loaded with stock and consequently have a deep, vested interest in bullishness, this market has persistently refused to take both Averages back over the 1966 bull market highs.

The great tide of the market, the primary trend, is receding. The movement is subtle, it is halting, it is resisting the downside the way a drowning man resists his fate. Yet the greater the struggle, the greater the final exhaustion. I feel that we will be approaching the exhaustion stage during late 1971 and 1972.

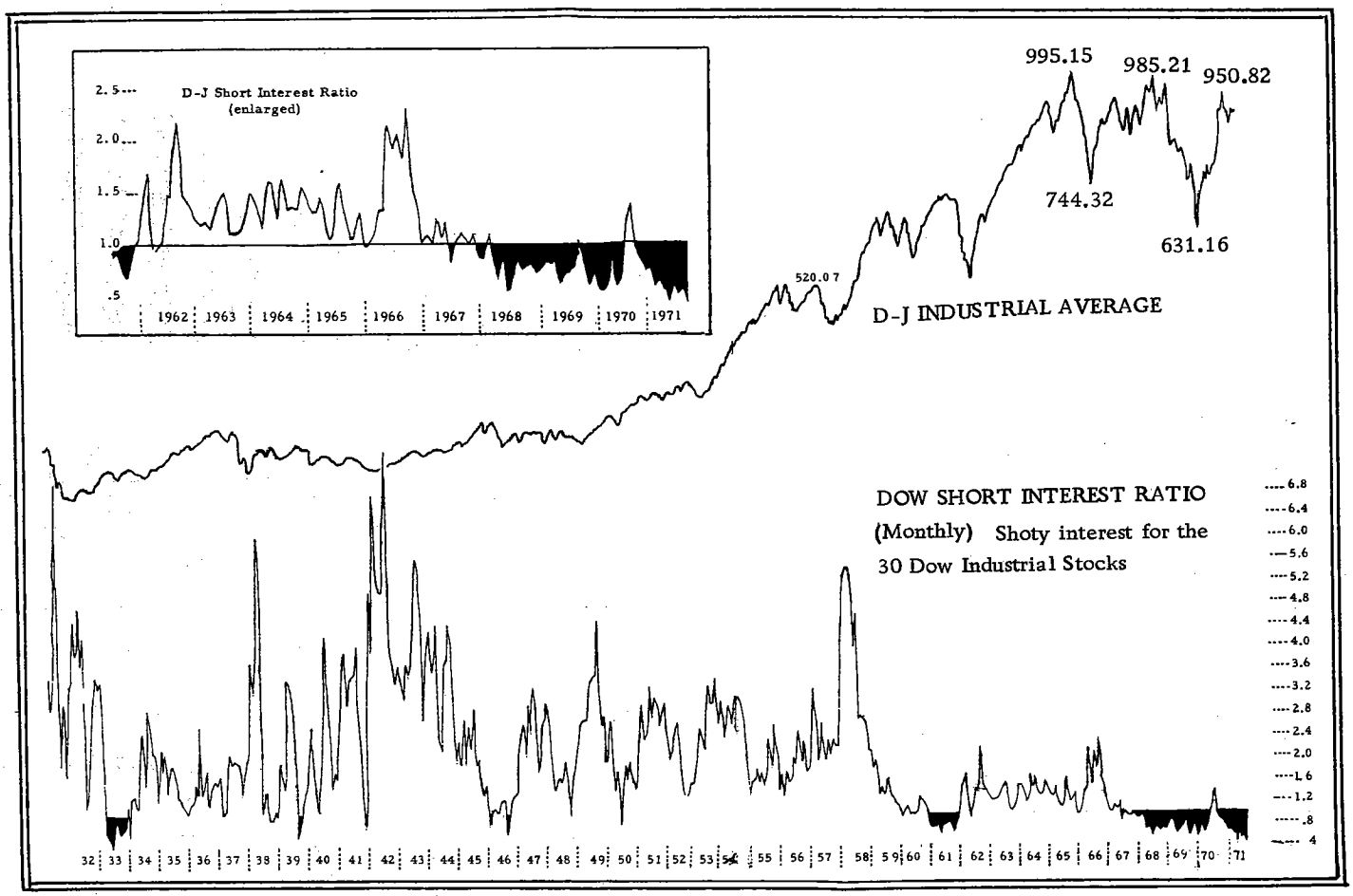
DOW SHORT INTEREST: For the period of mid-August to mid-September it was reported that the short interest ratio on the N.Y.S.E. was 1.10. This is a rather neutral figure, and not particularly significant. What is significant, however, is the reading of the short interest ratio in the 30 Dow stocks (DSIR). The DSIR was first uncovered by Bill Gordon of New York some years ago, and after studying its long-term chart, I concluded that the readings of the DSIR were superior in forecasting value to the widely-followed short interest ratio on the N.Y.S.E. I feel that I am entitled to make this comparison, since I believe I first popularized the short interest ratio in my Barron's article of December 28, 1959 ("Tell-Tale Ratio"). Up to that time, most Wall Streeters had never heard of a short interest ratio.

At any rate, the DSIR for the latest period (mid-August to mid-September) was an incredibly low .41. This occurred because of a rise in average volume in the 30 Dow Industrial stocks for the period and a drop in the total short interest in the 30 Dow Industrials from 617 thousand for the preceding period to 552 thousand for the period ending mid-September.

It is notable that this latest .41 reading is the lowest reading in modern history, and the second lowest reading in the 40-year computed history of the DSIR. Only the .37 reading of July, 1933, was lower than last month's .41.

Because of the current historically low figure, I am including a long-term chart (page 3) showing the entire history of the DSIR in this Letter. The smaller insert is simply a blow-up of the 1961-71 period, so that readers may examine the DSIR movements more closely. Note that there are only four large black areas on the chart. These are the areas in which the DSIR was below the critical 1.0 level. The three areas are 1933, just prior to the violent July to September smash; 1961, which preceded the violent 1962 collapse and the period of 1968 through early 1970. All through 1968 the DSIR was issuing its warnings, and during 1969-70 the market suffered its worst collapse of the generation.

During mid-1970 we saw a little build-up in the DSIR with the indicator getting as high as 1.40 in August, 1970. At the time I noted that this was the best reading in four years but certainly not the kind of reading one would associate with the



build-up around the beginning of a new bull market (see chart at the 1940-42 period or in the 1949 period).

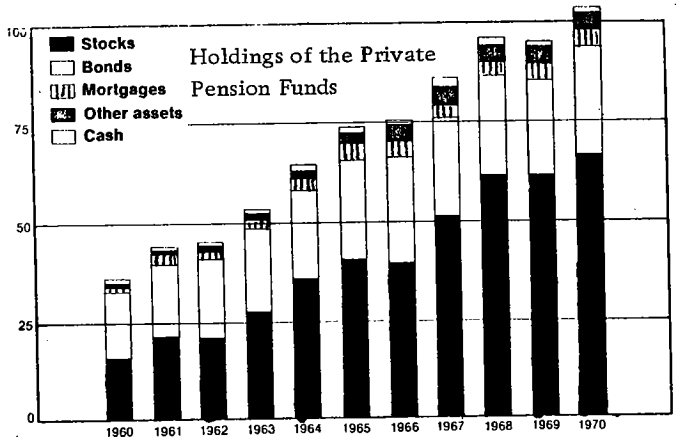
Following the August, 1970 peak of 1.40 for the DSIR, the figures began to deteriorate back into the black area, and by April, 1971, we saw a very low .53 for the indicator. This coincided with the 950.82 peak for the Dow, a figure which so far has not been surpassed in 1971. In May the DSIR dropped to an extremely low .42. The June figure was .59, July was .51 and August was .55 — all very low, bearish readings. Then we received September's .41, second lowest in history, and a danger signal worth heeding.

If you study the enlarged insert chart, you will note that the black (bearish) area of the DSIR during 1971 is the deepest of any black area on record. I can only surmise that the DSIR indicator is now issuing its sternest warning, a warning which is more ominously bearish than the 1968-69 warning. Remember, I don't "make" this indicator, I simply report on it and issue my interpretation. And my interpretation is "watch out". The DSIR is saying that in terms of the short interest and average volume, the 30 Dow Industrial stocks have no support under them. Bearishness regarding the Dow stocks (which should run high in a primary bear market) currently does not exist.

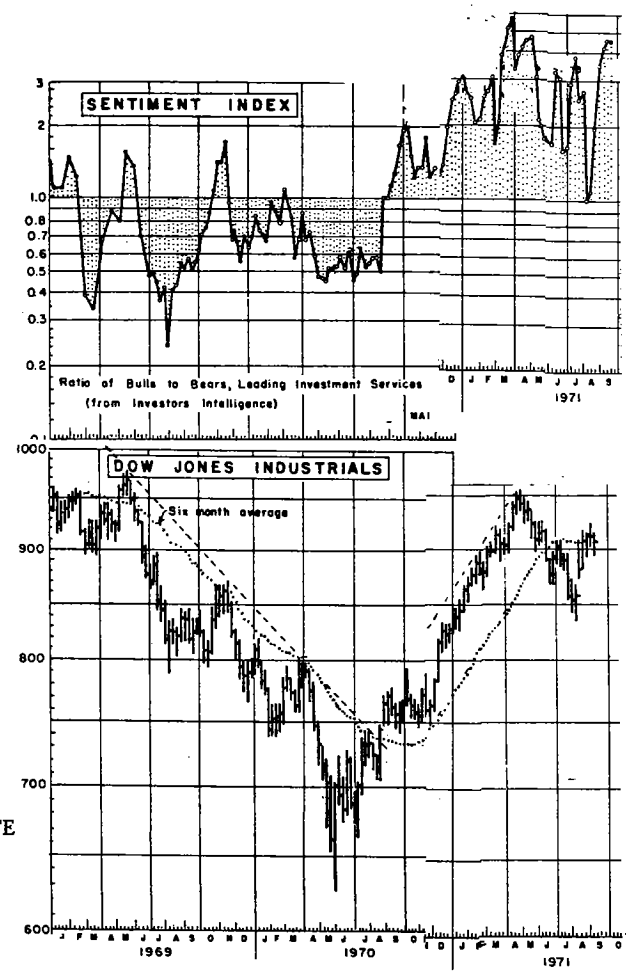
THOUGHTS ON THE BEAR: The great 1949-66 primary bull market ended on February 9, 1966, at 995.19 on the Dow. The Dow Industrial Average, since 1966, has not been able to better that high despite what must constitute the greatest continuing economic propaganda barrage in American history (see page 3 chart). Since 1966 the Dow Industrials have attempted on three separate occasions to better the 900 level, once in 1967, once in 1968 and most recently during 1971. The 1967 and 1968 efforts ended in failure as the power of the bear reasserted itself following each rally attempt. Subsequent to the 1967 attempt, the Dow slid to 825.13 in March, 1968. Following the 1968 push, the Dow collapsed to a 1970 low of 631.16. From there the Dow headed up during 1970 and 1971. The battle of 1970-71 is still on, but it is notable that the high point for this year stands at the April Dow peak of 950.82, this despite the almost unanimous opinions from Washington and Wall Street that "the worst is behind us" and that "a new bull market is on".

Very few men writing today understand what a primary bear market is all about. I know that almost no one in Washington (including Mr. Nixon) knows how a primary bear market operates. First of all, it must be remembered that bear markets have a habit of making hash of all the statistics, indicators and systems. Many of the indicators simply stop functioning

while the bear is on. Others become erratic, providing more traps than bullish signals. The reason for all this is that it is human nature to be optimistic and bullish. It is human nature for men who own stocks to want them to go up. Remember, the nation is now LOADED with stocks. The mutual funds (now 95% invested) owns almost $50 billion of stocks, the private pension funds (see chart) have been buying their heads off and now own around $70 billion of stocks. There are 30 million private investors in the market. All these individuals want their stocks to go up. And in their bullish desire they will temporarily influence the indicators towards the bullish side, but the bullish influence during a primary market is always, and I repeat always, temporary.



Today we find the markets at an extraordinary junction. The fact is that never have so many institutions and individuals been praying for stocks to rise. And all within the framework of a primary bear market, a period when the great tidal direction of the market and the economy is down. Now, let's not forget the investment services. They cater to the needs of investors. And most of the services do best when they write bullishly, when they provide what everybody wants to hear (I'm an exception, I guess, because I've been bearish since the 1966 top, and my subscription list is now at a 13-year peak, or the largest since I started in 1958). I include a chart (courtesy of Merrill Analysis, Box 228, Chapaqua, N.Y. 10514) which shows the current ratio of bullish to bearish investment services. Note what's been happening in 1971. The bullish services are now running 3 to 1, which is a mighty bullish count (but not very bullish for the market, for the simple reason that the majority of services tend to be wrong, and most wrong when they are nearest unanimity).



Another curious phenomenon is volume. During the whole bull market of 1949 to 1966, there were no trading days on the N.Y.S.E. over 20 million shares. All that while the tide of the market was up, and each Dow peak was bettering the previous Dow peak. Then came the bear market, and in February, 1966, the Dow turned down. By late 1966 the Dow was at 744.32. The first wave of the bear was over, and President Johnson came in with wild spending and whopping Vietnam War deficits. The public roared into the market along with the funds and the pensions and the insurance companies and the banks, and the market headed back towards 900. During 1968 we saw FOUR SEPARATE TRADING DAYS, EACH OVER 20 MILLION SHARES. That intense speculation gave way to the 1969-70 crash, as the market suffered its worst collapse since the bear market of 1937.

But with inflation surging and the Government opening the money valves, the public (and I include the funds in when I say the public) clammered back aboard. In 1970, TOWARDS THE END OF THE YEAR, THERE WERE FIVE DAYS OF 20 MILLION SHARES OR MORE. Now here comes the eye-opener for this bear market. IN 1971, SO FAR, WE HAVE HAD 24 TRADING DAYS OF 20 MILLION SHARES OR MORE. On August 15 we witnessed a record 31.7 million shares on the N.Y.S.E. as the market reacted wildly to President Nixon's Phase 1 plan. The Dow "gapped" up on that day, and closed at 888.95. If enthusiasm was needed, Wall Street provided it.

But let's consider for a moment. What does it mean that the 33 "over 20 million share days" previously referred to, all occurred after 1966, and while the Dow was below its 995.15 bull market top? To me, it means that we have seen one of the greatest areas of frenzied excitement and distribution in the history of Wall Street. All of which is extremely bearish for this primary bear market, because there is nothing more dangerous than frenzied investor action against the primary trend. We see that clearly enough when everybody sells and sells short during a big bull market reaction. Panic bearishness during a bull market means that in time the market will turn upward and roar to new highs, scattering the bears and rending the shorts as it climbs.

The same holds true during a primary bear market, and in time I believe investors, traders, stockholders and institutions in general will see what I mean. In time, we will have a downward movement which will sweep everything away in its relentless path, it will tear the very foundations of the market apart, it will convince everyone down to the last hold-out bull, that this is indeed a very serious, a very dangerous, a very drastic primary bear market.

As far as I know, no primary bear market in history has had to contend with so much bullish speculation, so much wild counter-trend enthusiasm, such relentless fighting from Washington against the trend. I shudder to think of what the end result of all this "spent ammunition" will be, once the primary bear gets in gear on the downside again. I can only say that it is a very, very dangerous situation, and the passage of time only makes it worse. I don't suppose I can be any stronger than that.

THE BATTLE: The 118-nation IMF is in session, and the newspapers are covering this so fully that it almost seems redundant to mention it here. The fact is that the European community and Japan are now faced with the tottering "American situation". The situation is the collapse of the dollar, the stubborn, arrogant attitude of the U.S. as espoused by Mr. Connally, and a series of U.S. protectionist tactics which have thrown the free world into consternation, anger and at best worry. Ironically, even while the meeting was on, the U.S. announced (see clip) that its reserves had fallen to the lowest point since the 1930's and that it has suffered (in July) its fifth straight trade deficit.

It's a strange picture, and I liken it to a giant (the U.S.) who has suffered a heart attack from years of excesses. His pygmy servants are all healthier than he is, but the giant has been boss for years and his strength has protected the pygmies. Now, as he reels in the throes of his heart attack, the pygmies are confronted with saving him (they still depend on him) or letting him fall. But if he falls, giant that he is, he could crush them all as he comes thundering to earth, still waving a mighty fist and still claiming that he is the strongest man on earth. The problem: how to convince the giant that he is sick, bloated, in poor health and that he must start re-examining his life in view of his heart attack.

At the IMF meeting Mr. Schweitzer set the tone by stating that the U.S. must remove its 10% surcharge and devalue the dollar against gold, and in turn the other nations would revalue their currencies upward and take other steps to ease the burdens of the U.S. Mr. Connally fumed about reversing the U.S. international payments by $13 billion plus aiming for a $10 billion surplus in coming years. This "mind-blower" has left the IMF wondering if Connally is in his right senses or simply jockeying for position. We can best liken Mr. Connally to a bankrupt businessman who is talking about expansion and new acquisitions next year.

At any rate, the attitude of the Europeans can be seen from this clip from the Sept. 26 British Manchester Guardian regarding the mid-September Group of 10 meeting. It's going to be a long, cold winter, it seems to me, before the U.S. rams its wishes down the throats of the Europeans and the Japanese. In the meantime, Europe (which now has more than twice as much gold as the U.S.) will be in position to test the old adage, "Who has the gold, gives the orders".

The ministerial meeting of the Group of Ten has proved a severe setback in the world monetary crisis: agreement was not to be expected, but the fact that it was not possible even to agree on an agenda for experts who meet as deputies for the Ministers means that matters are worse than they were. For this deplorable situation the Americans are almost entirely to blame, and candid friends of the United States are bound to say so in blunter language than Ministers can use between themselves.

The American position on the monetary issue is illogical and unacceptable. They refuse to discuss a gold price which they at the same time refuse to honour; and they equally refuse to clarify, in the context of parity changes, an import surcharge which is a breach of international agreement and is itself the equivalent of a parity change. This intransigence is exercised in defence of a point of view and a set of objectives which are equally unacceptable: that the rest of the world is entirely to blame for the US deficit, and that the world owes the US a surplus.

MUSINGS: All matter is subject to rhythms. From the electrons whirling around within the atoms which make up the cells which make up your body, from the seasons on the earth, from the movements of the earth around the sun and the sun's movements in the universe, all matter acts in time with rhythms. And all matter has vibrations, which are minute rhythms (the stock market has rhythms too, in case you weren't aware of it — actually they are called cycles).

I believe that whole sections of the earth give off their own vibrations as do nations themselves, states, cities, people, even

U.S. Reserve Assets Dip To 34-Year Low

WASHINGTON (AP) — The nation's holdings of international reserves, including gold, dropped by more than $1 billion in August, one of the steepest monthly declines in U.S. history, the Treasury Department said yesterday.

The department said the nation's reserve assets fell from $13.283 billion in July to $12.128 billion in August, a drop of $1.155 billion.

It put the nation's reserve assets at the lowest level since 1937. Treasury officials said they could not recall a similar decline in reserve assets in one month, although they left open the possibility that it could have happened.

The nation's gold stock declined by $244 million to $10.209 billion, part of which came through a $191 million gold sale to France early in August.

The continuing decline of gold reserves was one reason why President Nixon chose to cut the dollar loose from its tie with gold Aug. 15 and float the dollar in international exchange market.

Also dropping in August were the U.S. holdings of convertible foreign currencies, by $2 million.

animals. Those vibrations can vary tremendously; some are "good", some are "bad", some are saintly, others are evil or psychotic, and still others are neutral. Did you ever see Jack Palance, the fantastic villain of the movie "Shane"? He gave off some of the most evil vibrations I have ever seen. Men who I felt exuded very good or high vibrations were Ghandi, Krishnamurti, De Gaulle to some extent, and many others which I cannot think of off hand.

I always got very bad vibrations from the Eastern U.S. (no offense Easterners, please), but this is one of the reasons I moved to the West. I get fairly good vibrations from the West in general, although I must say Los Angeles gives low (somehow dirty) vibrations, and San Francisco gives very mixed vibrations (some good and some bad, I've never felt such a mixture of good and bad vibrations as in San Francisco). I suppose New York has the worst vibrations I ever felt (except possibly Philadelphia and the New Jersey cities of Newark and Hoboken). I used to get fearful vibrations in the South, but these are improving now.

The best vibrations I ever received have been around San Diego (but not necessarily in the city). The coast from Del Mar down to La Jolla and Mission Beach give me great vibrations, a feeling of freedom and wonder and cleanliness and hope.

Up in the mountains around Dulzura in back-country San Diego (about an hour'sdrive from here) I've felt some of the best vibrations I have ever felt. Here, in this high, dry magnificent country overlooking Mexico (it's just a few miles from Mexico, actually) one feels close to nature and to the powers that be. It's unspoiled country, and if one gets up early in the morning he may see deer, rabbits (dozens of them), perhaps a fox, horned toads, and the full carpet of nature spread out before him. It fills a man's soul with a sense of the earth, the undamaged earth, the grandeur of God.

I've been alot of places from Brazil to Africa, from Key West to Italy, but I've never felt anything like the San Diego back country. Much of Africa has the same magnificence and more so, but there are also danger vibrations. I get really good vibrations along the Coast north of La Jolla and in back country San Diego along route 94 towards the mountains and towards Tecate, Mexico. Anybody who wants to try it has my blessings. But be careful — you may never go home again. I didn't (I left N.Y.C. in 1961).

The huge, clean, white beach of La Jolla has been crowded with people all summer long. Then, suddenly after Labor Day (with the weather still wonderful) the beach is empty. Yesterday, (only a few weeks after Labor Day), I walked about three miles along an almost deserted beach thinking, "People live by habit, not the situation. Here I am, almost alone on a three-mile beach, the weather is perfect, but people simply cease going to the beach after Labor Day. It's really a study in mob psychology. What makes people suddenly avoid the beach after Labor Day? Perhaps it's because everybody else stops going. But why does everybody else....? It must be like the tidal movement of the market. Why do the tides occur? Who knows, but they do occur, just as surely as the beach population clears off and disappears after Labor Day, regardless of the weather.

GOLD: Last week, as seen on the accompanying gold chart, the price of the yellow metal jumped in London to $43.57, just short of its year's high. Silver, in the meantime, held low at what I think is the bargain level of around $1.40. At the IMF meeting a number of delegates brought up the spector of an international depression, and it is obvious that if the U.S. wishes to bring about a $13 billion reversal in its payments, that $13 billion must come out of our trading partner's collective payments balances. If so, world trade could come to a slow, grinding halt. All of which would ultimately militate in favor of a much higher gold price. The final high price may come in the midst of world chaos, even though a "somewhat" higher price (say 10% to 15%) might be agreed upon now. At any rate, it appears increasingly sure that gold is not going out of style in this century, despite the fervent hopes of U.S. politicians.

NOTE: I want to take a little space to thank all my subscribers who have written to me over the past few months. I blush to say that I simply cannot answer most letters— but I love getting them. I also want to thank those who send the dozens of valuable press clippings. I could not possibly pick up all that information myself, but with hundreds of eyes working, the net result is that I have a continual influx of fascinating articles which help me tremendously in putting out these reports. So thanks to all, and apologies for not answering all letters.